

## **Testimony of**

**Diann L. Smith, Esq.**

**General Counsel, Council On State Taxation (COST) 122 C Street NW, Suite 330  
Washington, DC 20001 202/484-5215, dsmith@statetax.org**

### **On the Issue of Draft Model Uniform Statute on Compilation of State Tax Return Data – Part II**

**Before the Multistate Tax Commission  
September 7, 2006**

The Council On State Taxation (COST) vigorously opposes the Multistate Tax Commission's (MTC) concept of a "Uniform Statute on Compilation of State Tax Return Data". In this document, COST addresses the substantive problems with this concept. In a separate document, COST questions the procedure by which this proposal has now come before the Commission. This requirement, also called a "51 state spreadsheet", is fundamentally flawed and thus COST offers no suggestions for changes or revisions to the proposal.

COST's substantive opposition to the proposal is based on two general reasons. First, the proposed filing requirement would create significant additional and unnecessary data collection and administrative filing and financial burdens because many large multistate businesses do not currently have an automated capability to collect the requested data in the proposed format. Second, the laws and rules among the states themselves do not offer uniformity or easy comparison, and thus the data collected would be at best worthless and at worst an added audit burden to both the states and taxpayers as legitimate differences are unnecessarily investigated.

*Administrative Burden Unacceptable:* The MTC has suggested that states implementing such a filing requirement delay the implementation until 2009 to provide taxpayers and software developers time to design appropriate automated systems. COST notes that in a perfect world software would be the great panacea, but the lengthy and ongoing time period to create and implement two other recent "software fixes"—SSTP and state corporate e-filing (Utah, a vocal supporter of the MTC proposal, has not yet been able to find a software provider to create a corporate e-filing system for its state businesses)—should make everyone skeptical of relying on the "software" solution to administrative burden issues. Even should software be developed, the cost of this new software will be an additional compliance cost burden born by taxpayers.

As an alternative, the MTC Executive Committee has apparently included in the proposal to be adopted by the Commission an option for taxpayers to file copies of tax returns from all other states in every state in which the taxpayer is subject to tax. The idea that offering multiple copies to many states of dozens of returns as an administrative convenience is almost laughable. As one COST member commented, the MTC is apparently mandating the leveling of the nation's forests through this "option." In addition to not offering a legitimate option to the increased administrative and financial burden the proposal would place on multistate business taxpayers, the scope of the option is frustratingly murky. Would this "option" require the filing of: copies of an entire return or just selected segments, copies of amended returns, or copies of other members of the taxpayer's federal consolidated, state combined or consolidated, or other affiliate group returns? None of these questions have been asked by the Commission much less answered.

Thus, the administrative and financial burden remains a fundamental flaw of this proposal.

*Substantive Uselessness of Proposal:* More importantly, even if the filing and data collection burden could somehow be fixed with software, it is impossible to understand and meaningfully compare the various requested tax calculations between states when the underlying substantive tax law is not only not uniform among the states, but the proposed categories in the spreadsheet offered as a draft example by the MTC by necessity include aggregations of dozens of non-uniform determinations. Thus, within each category subject to reporting, there is in essence an exponential pyramiding of non-uniformity and the parallel non-comparability of the information making any determination based on the information provided in such a spreadsheet impossible absent significant additional investigation. This additional investigation can only increase the complexity of an audit without any obvious trade-off in increased compliance. The auditor will spend a lot of time finding non-uniformity of the law, not non-compliance by a taxpayer.

The MTC's belief that the spreadsheet will add to the efficiency of the audit is woefully naïve. According to the MTC Hearing Examiner's Report on the proposal, the "spreadsheet would allow auditors to compare a taxpayer's filing position in their state with the filing position taken in another state known to have comparable laws, without requiring the taxpayer to make those comparisons." COST is unclear how a state would determine which other states have "comparable laws" because it would require someone in the state to be very familiar with the statutes and interpretations of complicated tax laws of other jurisdictions and also would require a determination, particularly when many different tax issues are aggregated within one category on the spreadsheet, as to when a law actually is comparable enough. With the aggregation of many items within a reportable category, even calculations under "comparable laws" will be bundled with calculations under noncomparable laws making the aggregate amount reportable completely opaque as to state-by-state compliance.

The goals of requiring the spreadsheet, according to the Hearing Examiners Report are: "1) serve as a scoping to gain an understanding of how the taxpayer filed . . . and identify potentially inconsistent positions. . . . [and] provide sufficient information to complete a comprehensive scope thereby reducing areas of inquiry; 2) serve as a tool for narrowing audits; 3) greater transparency; and 4) identify nowhere income . . . and to understand how the taxpayer reported in each state for the purpose of uniformity." COST questions how any of these goals can be met with the concept of the 51-state spreadsheet since the non-uniformity at every level of the corporate income tax calculation does not appear to allow for any comparison among state tax calculations and this lack of comparability will lead, at best, to the states ignoring the filing (which is a complete waste of the taxpayer's effort in reporting it) or, at worst, an increase in audit inquiries to taxpayers by the states in attempts to understand the information with little increase in deficiencies found. COST worries that the only real goal behind the proposal is the goal of making sure that all income is taxed at least once by the states despite the fact that such a goal has no support in current tax law.

COST notes the following non-uniformity items leading to significant state-by state differences which would not be apparent from the data alone:

- a) States Without Income Taxes: because the spreadsheet only applies to states with "taxes based on income", quite a few states will be excluded from the data filing requirement entirely (even though the current draft includes all states, this is contrary to the accompanying instructions). MI, OH, TX (maybe), WA, and NV for example will not be reflected, and thus adding up items such as the numerator for the factor numerators or allocable/apportionable income for all reported states will never equal

100% of the national total. Whether the possible difference is because not all states are included or because the taxpayer is “hiding” issues from the tax authorities will never be apparent.

- b) Filing Method: the current draft of the spreadsheet seems to assume—almost laughably—that there is some type of uniformity of tax terms among the states so that by requiring a taxpayer to note whether it has filed separate, worldwide combined, water’s-edge combined, nexus consolidated, or “other” will somehow neatly provide the taxing authority with information as to whether the taxpayer is improperly using different filing methods in different states. The model statute itself falls into the definitional trap by notwithstanding the draft spreadsheet distinctions, defining a combined return to include a consolidated return. The statute does this even though there are clearly very real differences if a taxpayer is to report how it actually filed in any given state and, as noted, the draft spreadsheet actually requires a distinction.
- c) Total Income: the instructions state that this number is the total amount before state adjustments and for a combined group it is the total for the combined group. Of course, once the total is on a combined basis, any difference in what entities are in the combined group—such as different ownership thresholds, prerequisite of distortion, statutorily excluded companies, foreign income inclusion rules, 80/20 companies, etc. will likely lead to huge variations in the total income reported to various states.
- d) Total Allocable Income: COST notes that the lack of actual uniformity and the concomitant impossibility of reaching comparability conclusions worsen as the tax calculations become more granular. Laws on what income is allocable are completely non-uniform. There are: differing court determinations on scope of the “business/nonbusiness” classification; states that have abandoned the business/nonbusiness concept and substituted a “constitutional apportionment” standard; states that have completely different laws (e.g., LA and NY); differences in the treatment of pass-through entity income/distributable share determination level; and differences in determining allocable expense categories, just to name a few of the obvious state-by-state differences.
- e) Total Apportionable Income: COST just cannot imagine how this could ever be meaningfully compared among states. All of the differences noted above will obviously affect this category, plus the plethora of state specific adjustments including: DRD calculations; NOL rules; federal decoupling and expenses paid to affiliate add-back rules.
- f) Calculation of Factors: COST concludes its review by noting just a few of the differences encountered in factor calculation and sourcing for numerator purposes. These differences include: i) Property Factor: determination of whether income from property is nonbusiness thus excluded; inclusion of property owned and leased among affiliates; including property at fair market value or cost value; ii) Payroll Factor: inclusion of leased or loaned employees and independent contractors; iii) Sales Factor: throwback/out rules; market vs. cost of performance sourcing; and the determination of what items are included within cost of performance.

In conclusion, the non-uniformity of the laws between the states and the aggregation of the application of many different non-uniform laws in the calculation of the amount in any one category make it impossible to “scope” the spreadsheet for inconsistent filing problems and

will thus make the new filing, at best, useless. COST suggests recent developments in tax administration—such as ever increasing information exchanges between state tax authorities and new, potentially more exacting standards for recording an income tax benefit for financial statement purposes—may address or allay concerns that give rise to the MTC’s interest in a 51-sheet spreadsheet.